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TAGS: EFIN EINV BEXP TU
SUBJECT: FOREIGN PORTFOLIO INVESTORS FIGHT WITHHOLDING TAX ON FINANCIAL INSTRUMENTS

1.(U)Summary: The Turkish Parliament approved a tax bill at the end of 2004, which introduced a withholding tax of 15 percent on all gains on all financial instruments, including equities and fixed income securities. The law comes into effect as of January 1, 2006. The law is designed to increase tax revenue and both to level the playing field between foreign and domestic investors and between different types of financial instruments. As the implementation date approaches, with some uncertainty over the law's application, it has become increasingly controversial, with major international investment banks, many of them U.S.-headquartered, trying to convince the GOT that the law as written discriminates against foreign investors, will damage the derivatives market, is unworkable, and could disrupt the market. Turkish Treasury seems to be sympathetic to some-- but not all-- the investors' complaints but needs to convince a recalcitrant Finance Ministry. Investors have tried to draw in the IMF, but the Fund seems disinclined to get heavily involved. End Summary.

International Investment Banks Press the GOT:

¶2. (SBU) The Turkish Parliament adopted a bill in December 2004 to introduce a 15 percent withholding tax on income from all financial instruments. For the first time, government securities will be taxed. The tax will become effective as of January 1, 2006. The law's passage was not widely-noticed at first-there was negligible press coverage and Embassy Ankara only began to hear about the issue in June from visiting foreign bankers. According to London-based investment bankers such as Credit Suisse First Boston, Lehman Brothers and Merrill Lynch, the GOT consulted the financial community at an early stage but relied on banks with a local presence. Though foreign banks with local presence, such as Citigroup, were included, the interests of the other major international banks, who represent the bulk of the foreign portfolio investors were not taken into consideration. The visiting international bankers claim that Citibank, as the leading custodian bank, was mainly interested in avoiding having responsibility for collection of the tax being placed on the custodial institution.

¶3. (SBU) Since June, the major international banks, many of them with headquarters in the U.S., have been visiting Ankara frequently and pressing the GOT to take their concerns into account, even while trying to enlist IMF and U.S. Government support. The CSFB and Lehman Brothers bankers pointed out to econoff that out of some $20 billion of foreign investor holdings in Turkish financial markets, they estimate that 40 or 50% ultimately come from U.S. investors, whether wealthy individuals, pension funds, hedge funds, or financial institutions.

Treasury Listening to Investors:

¶4. (SBU) To the GOT's credit, when the foreign banks ratcheted up their complaints, Turkish Treasury and the Tax Administration (under the Ministry of Finance) met with the bankers and allowed them to make their case. Though the Tax Administration proposed the tax and has the lead on tax policy, Turkish Treasury has long been careful not to have the GOT take actions that could disrupt the market. Though Turkey's financial vulnerabilities have come down substantially over the past two years, Treasury still has to roll over billions of dollars of short-dated securities every month. The Tax Administration, on the other hand, is driven by a desire to capture more tax revenue, and to have a coherent tax policy that taxes all financial instruments equally. As such, it reportedly has not been sympathetic to the bankers' arguments.

Is the Tax Discriminatory?

¶5. (SBU) The international bankers assert that the law will

have a greater impact on foreign investors than on local investors. If the law will be put into application as currently drafted, it requires a retrospective taxing on the gains of fixed income securities issued prior to January 1, 2006 for foreigners and/or foreign investment banks. Accordingly, the tax will be levied on fixed income securities with no offsets for losses, funding or administrative costs.

¶6. (SBU) The foreign banks also claim that even if the new legislation avoids double taxation of foreign investment in equities, there is a risk of double taxation of fixed income securities. Some press reports claim that the Finance Ministry (MoF) opposes exempting foreign investors from the withholding tax, but there have been repeated press reports that the GOT might decrease the rate to 10 percent from 15 percent for all investors as the 2006 draft Budget is finalized on October 17. On August 2, however, the financial daily Referans reported that Minister Unakitan has rejected any lowering of the tax rate. Turkish Treasury Deputy Director General Volkan Taskin told econoff and econ specialist that the GOT was also working on an amendment to prevent discriminatory application against foreign investors and may decide to apply the withholding tax only on the instruments issued as of January 1, 2006 for all investors. The MoF is expected to reach at a decision on the issue this week.

¶7. (SBU) The allegation of discriminatory treatment relies principally on the question of the applicability of double taxation agreements. The new law will actually replace the financial instruments tax law adopted in 1999, and aims at bringing a single tax rate to all financial instruments, including bank deposits, in Turkey. Turkey has double taxation agreement with 60 countries, including Netherlands, Britain, France, Germany, Italy, and the U.S. The agreement already regulates taxing of gains on securities in the source state. The agreed rates range from 10 to 25 percent depending on the country. For example the rate is 10 percent on interest gains with the U.S. and 15 percent with the U.K.

¶8. (SBU) London's leading investment banks submitted a joint report to Minister State Babacan on July 6 explaining the concerns of foreigners on these developments. In the report, bankers highlighted the following aspects of the law:

-- Differentiation in the treatment between local and foreign participants. Local investors would appear to have greater scope to deduct the new tax, whereas in certain situations-such as when there is a group loss-foreign investors might not be able to deduct the tax. Moreover, according to the foreign bankers, there is a considerable confusion and misunderstanding with respect to the different tax treatment of securities issued earlier and held as of December 31, 2005 with respect to different classes of investors.

-- Availability of Double Tax Treaty benefits: The law causes uncertainty regarding the applicability of Double Tax Treaties to foreign investors holding t-bills. In most markets, Double Tax Treaties would exempt relevant foreign investors from local tax, which is not always the case under Turkey's double taxation treaties. One key issue is whether government securities are considered "listed securities," which is necessary for them to be covered by double-taxation treaties. Currently, there are different interpretations: with Treasury asserting government securities are listed and MoF disagreeing.

-- Risk of Limiting development of the derivatives market: Uncertainty of withholdings on underlying instruments will limit the development of the derivatives market.

-- Application of the new law: Neither investors, intermediaries nor custodians will be able to administer the draft law effectively, and the market will be affected by uncertainty and excessive compliance cost.

-- For all these reasons, the banks assert there is a risk of market disruption, as foreign investors reduce their holdings. They also point out that foreign investors played a critical role in Turkish Treasury's recent success in issuing longer-dated securities, extending the yield curve with three- and five-year issues.

Treasury Generally Sympathetic:

¶9. (SBU) Econoff and Econ specialist met with Volkan Taskin, DDG of the Public Finance Department of the Turkish Treasury, which is the office managing the Turkish state's domestic borrowing. According to Taskin, Treasury never favored taxing any financial instruments, but it the MoF had insisted on the law to increase its revenue collection. Capital Markets Board Chairman Dogan Cansizlar also told us he had opposed the new law, preferring a smaller transaction

tax, an idea the foreign bankers told us they would be more amenable to. The business daily Referans reports that the MoF estimates it will collect an additional 5.7 billion YTL (about $4.2 billion). Taskin also noted that this law will enable Turkish authorities to track the investors who are investing in Turkish securities. According to Taskin, the new law actually brings benefits to custodians since it will reduce the 30 percent tax rate on their gains to 15 percent, but will be negative for foreign investors and intermediaries. Taskin agrees that current double taxation treaties do not adequately address the issue. Taskin also expects some sell-offs towards end of the year because of the tax's effect on government securities, but could not estimate the real impact and how much rates may increase as a result of this tax. He also agrees that the new arrangement will require banks, intermediaries to rearrange their accounting systems, and will bring an additional IT cost.

¶10. (SBU) Econoff also heard through an IFI official that Treasury Under Secretary Ibrahim Canakci, who sat through several long meetings with the foreign bankers, is sympathetic to some-but not all-of the foreign bankers' complaints. For example, he is unsympathetic to the bankers' allegations that tracking and administering the tax is impossibly expensive, an allegation that one Turkish investment banker also made to econoff. Taskin and, reportedly, Canakci, see the need to make government securities unambiguously subject to double-taxation treaties by specifying that they are "listed securities." Taskin even asserted Treasury would and could do this with or without the Tax Adminstration's agreement. The IMF Resrep told econoff that by making the securities listed, the foreign investors' problems would largely be solved.

Local Banks Begin to Complain:

¶11. (SBU) On July 29, the local financial press began to report that local banks had become alarmed about the tax and had met with bank regulators and GOT officials to express their concern. According to the press reports bankers had a meeting with MoF officials this week, but could not convince the officials about negative implications of the withholding tax. Bankers met with e BRSA (Bank Regulation and Supervision Agency) July 29, and reportedly asserted that the 15 percent withholding tax will also lead to an increase in banking costs. Bankers mainly focus their complaints on the withholding tax to be applied on financial derivatives, like swaps. Turkish banks, that have recently increased borrowing from foreign banks through syndicated foreign exchange-denominated loans, hedge themselves through swap operations. This complaint echoes the foreign banks' fears of the impact on derivatives: the foreign bankers explained to econoff they market complex structures such as "total return swaps" which could unravel if the underlying securities start to be taxed.

How Disruptive?

¶12. (SBU) The local bankers are also reportedly concerned about the potential outflow of foreign portfolio investors, many of whom hold Turkish bank deposits, in addition to government securities and equities. In the equity market, foreigners are widely-considered to hold roughly 60% of the free float on the Istanbul Stock Exchange. Some analysts comment that 21 percent of Turkey's traded domestic debt is held by foreign investors. According to Turkish Treasury DDG Volkan Taskin, this amount can go up to 55- 60 percent from time to time.

¶13. (SBU) Clearly, foreign investors play a critical, even dominant, role in Turkish financial markets and in financing Turkey's yawning current account deficit. The key question, then, is whether the foreigners would really pull out if the tax is not made more foreign-investor friendly. It would appear that efforts to list and other doable changes make a major market disruption unlikely.

¶14. (SBU) The IMF seems to be of this view, given its apparent reluctance to get too involved. When econoff raised the issue with the Resrep he seemed disinclined for the Fund to get too involved, preferring to let Treasury work things out with investors. The Fund has grudgingly agreed to have its tax mission take a look at the issue, but he said it will only have limited time to spend on the matter.

¶15. (SBU) If, on the other hand, the confusion over government securities being listed is not cleared up, and/or the foreign banks are correct about the tax being unworkable, there could be disruption, particularly if combined with significant market-unfriendly news flow over the IMF and EU, or a reduction in global liquidity. While a small correction would actually be desirable, since foreign

investors pulling out would disproportionately affect the foreign exchange market and correct the overvalued lira, a large correction would be highly disruptive.

McEldowney